

Sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met. See 86 Ill. Adm. Code 130.2115. (This is a PLR).

May 14, 2001

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (which can be found at <http://www.revenue.state.il.us/legalinformation/regs/part1200>), is in response to your letter of March 23, 2001 and our telephone conversation on April 16, 2001. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

I am writing to you requesting a Private Letter Ruling (PLR), pursuant to 2 Ill. Admin. Code Sec. 1200.110, addressing the sales and use taxability of a material-handling conveyor system (the conveyor) which a certain company has purchased. PLRs respond to inquiries made by taxpayers or their representatives under power of attorney (attached). Further, we understand that PLRs discuss tax principles or applications and are binding on the Illinois Department of Revenue (the IDOR) to the extent that the material facts of the situation remain the same, and the law relied upon in the ruling does not change.

FACTS

The COMPANY owns retail stores throughout Illinois. It supplies the stores from a distribution warehouse (the warehouse) located in CITY, Illinois. To streamline inventory operations and achieve cost efficiencies, COMPANY contracted with BUSINESS to build and install a specially-designed conveyor for use at the warehouse. COMPANY uses the conveyor to account for and hold inventory purchased from suppliers and to pick and ship it to retail stores when needed.

COMPANY in considering design requirements had to have the conveyor engineered to conform to the particular size and shape (i.e., the floor plan) of the existing warehousing facility. (The warehouse is composed of an older section and a new addition.) While requiring that the conveyor meet current warehousing dimensions, COMPANY also intended that the conveyor accommodate future expansions, variances in stock sizes and types, and technological changes necessitating its modernization.

To meet the aforementioned requirements, COMPANY chose the BUSINESS over other competitors for its business. BUSINESS was chosen because of its reputation in the industry. BUSINESS's website and its other promotional materials indicate that it considers itself an industry leader in engineering, designing, and manufacturing material-handling systems and in developing products for meeting its customers' specific application requirements.¹

BUSINESS's 147-page Sales Proposal (and design plan) evidences that it contributed substantially to the detailed configuration of the conveyor. The Proposal specifically addresses how BUSINESS would execute the unique mechanical "design of nonstandard equipment components and the integration of standard and nonstandard equipment into an operational [conveyor] system." Proposal from BUSINESS, p. 2. The document also explains how BUSINESS's engineering (and computer automation) skills would meet the challenges posed by the precise space and movement limitations at the warehouse. (Exhibit A, attached herein, includes a portion of the Sales Proposal summarizing the design plan.)

The design, engineering, fabrication, and installation of the conveyor required that BUSINESS draw up 65 blueprints outlining its composite layout. The blueprints illustrate the exact nature of the conveyor's floor and ceiling supports--including their angles and elevations--and the precise placements of its sensors, scanners, sorters, slider beds, chutes, rollers, and spans of treads, all in conformity with the unique design elements required. Indeed, the blueprints convey many special details of the conveyor needed to conform to the peculiar floor plan and dimensions of the warehouse for which it was created--namely, the speed and lengths of its belts at specific points (including floors, ceilings, and walls), turns, crossovers, curves, ascents and descents, and the placement of feeder and takeaway lines. (Exhibit B, attached herein, includes three of the 65 blueprints drawn.)

The costs of design and engineering services, fabrication labor, and installation represent approximately 60-70 percent of the conveyor's selling price to COMPANY, while direct material costs represent approximately 30-40 percent². It is possible that the conveyor could be dismantled and erected at another warehousing site. Practically speaking, however, it would be prohibitively expensive to do so--in other words, equivalent to purchasing a new conveyor--since another set up would entail the redesign and reengineering of the conveyor, plus the reintroduction of nonstandardized parts necessary for conforming the conveyor to the spatial requirements of another location.

ISSUE

With respect to COMPANY's purchase of the conveyor from BUSINESS, what is COMPANY's sales and use tax obligation?

STATEMENTS

COMPANY is currently under audit by the IDOR, however, the issue presented in this PLR is not being examined as a part of the IDOR audit, nor is it pending in litigation in a case involving COMPANY. To the best of our knowledge, the IDOR has not previously ruled on the same or similar issues for COMPANY, nor has COMPANY submitted a

petition on a similar issue and withdrawn it before a letter ruling was issued. The IDOR did issue a General Information Letter (GIL) on this issue, which has been enclosed.

LAW

Illinois imposes a Retailers' Occupation Tax (the ROT) on persons engaged in selling within the state tangible personal property at retail. 35 ILCS 120/2. Illinois also imposes a Service Occupation Tax (the SOT) on servicepersons who transfer tangible personal property as an incident to making a sale of service in the state. 35 ILCS 115/3. A Service Use Tax (the SUT) is imposed on the use of tangible personal property acquired as an incident to the sale of a service in the state. 35 ILCS 110/3. The SUT complements the SOT. 35 ILCS 110/3-55. Further, when a serviceperson designs, develops, and produces special-order machinery or equipment, the SOT applies and is measured by the cost price to the serviceperson of the tangible personal property transferred to the service customer. 35 ILCS 115/3-10. "Cost price" means the consideration that the serviceperson pays to its supplier for the tangible personal property which it transfers to its service customer. 35 ILCS 115/2.

Pursuant to an IDOR regulation, special-order machinery is produced when (1) the purchaser employs the seller specifically for its engineering and design skills to produce a machine to meet the purchaser's particular and unique needs; (2) the machine has use or value only for the specific purpose for which it is produced, and (3) the machine has use or value only to the purchaser. The regulation adds that, in the case of special conveyors, the sale would receive SOT treatment even if a fairly substantial portion of the conveyor were made of standard parts or raw material (such as steel) which can be stocked for sale. 86 Ill. Admin. Code Sec. 130.2115(b) and (c).

Illinois case law addressing conveyors also stipulates three criteria for identifying special-order property subject to tax under the SOT: (1) The seller contributes substantially to the design of the product. (2) The property have use or value only to the purchaser. (In other words, the property has to be produced according to special requirements peculiar to the purchaser and not common to others whose conditions for possible use of the property are reasonably comparable to those of the purchaser.) (3) The equipment only has salvage value to others and therefore is useless to anyone but the customer for whom it is produced. Caterpillar Tractor Co. v. Department of Revenue (Illinois Supreme Court, 1963).

ANALYSIS

The conveyor meets the requirements under Illinois law for designation as special-order property for the following reasons:

- COMPANY chose BUSINESS because it is an industry leader in designing and engineering conveyor systems to meet customer's specific application requirements.
- BUSINESS's 147-page sales proposal/design plan and 65 engineering blueprints demonstrate that the conveyor had to be created to fit the exact and unique specifications of the existing warehouse structure.
- Emphasis on BUSINESS's design and engineering skills is underscored by the fact that approximately two-thirds of BUSINESS's production costs were attributable to services--design, engineering, and installation services, and

fabrication labor--while only one-third were attributable to direct-material purchases.

- As evidenced by the design plan and accompanying blueprints, the conveyor was especially created only for use at COMPANY's warehouse in CITY, Illinois.
- The conveyor has value only to COMPANY. It could be dismantled and set up elsewhere, but the costs of doing so would approximate those attached to purchasing a new conveyor.

Thus, applying state law to the facts in the current case, the conveyor should be considered special-order machinery subject to tax under the SOT. Accordingly, the tax should be measured by the cost price to BUSINESS of the tangible personal property (i.e., the direct materials) which it transferred to COMPANY.

CONTRARY AUTHORITY AND DISCUSSION

The IDOR might argue that the conveyor is taxable under the ROT, as measured by its full retail-selling price, because it is a stock item. In other words, it was created from standard parts which might be disassembled and then reassembled for use at any other warehousing facility.

In response, the following points should be made:

- The conveyor as fabricated and installed can only be used by COMPANY for the purposes for which it was designed.
- Its deployment at another warehouse would not be cost effective relative to fabricating an entirely new conveyor for the other site.
- An IDOR regulation states that a special conveyor does not lose its otherwise special-order status even though it is built substantially from standard stock parts.

IDENTIFICATION OF INFORMATION TO BE DELETED

We respectfully request that the IDOR delete COMPANY and BUSINESS's names from the publicly disseminated version of the PLR. Further, we respectfully request that the IDOR delete the attached exhibits--Sales Proposal (Exhibit A) and Special Conveyor blueprints (Exhibit B)--because these exhibits disclose specific contractual terms and agreements reached by both COMPANY and BUSINESS.

CONCLUSION

Based on the foregoing, please confirm that the facts of the case support the finding that COMPANY's purchase of the special conveyor should be taxed under the SOT and be measured by BUSINESS's cost price of the materials transferred to COMPANY. Therefore, COMPANY owes SUT on its purchase of the conveyor, and the tax should be measured by the cost to BUSINESS of the tangible personal property (i.e., the direct materials) transferred to COMPANY. This conclusion is consistent with state law and IDOR regulations.

We respectfully request that the IDOR send to us on behalf of COMPANY a PLR addressing the issue presented. Your cooperation is appreciated.

In addition to your written request, you informed us in a telephone conference the purchase order acceptance for this transaction occurred outside of this State and that the materials for the creation of the conveyor system were taken from inventory located outside of this State.

DEPARTMENT'S RESPONSE:

Sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met:

- A) The purchaser employs the seller primarily for his engineering or other scientific skill to design and produce the property on special order for the purchaser and to meet the particular needs of the purchaser;
- B) the property has use or value only for the specific purpose for which it is produced; and
- C) the property has use or value only to the purchaser.

Part (5) of subsection (b) of 86 Ill. Adm. Code 130.2115 states that "[I]n the case of special assemblies such as special conveyors, the sale does not become taxable (if it would otherwise be exempt under this subsection (b)) merely because a fairly substantial portion of the completed product is made of standard parts or of raw material (such as steel) which can be stocked for sale."

Based upon the information contained in your letter, we believe that COMPANY Co.'s purchase of the conveyor system described in your letter is a purchase of a special order conveyor system as described in subsection (b) of 86 Ill. Adm. Code 130.2115. Consistent with the Illinois Supreme Court's decision in Velten & Pulver, Inc. v. Department of Revenue, 29 Ill. 2d 524 (1963), the sale of this special order conveyor system is not considered a sale at retail and is subject to tax under the Service Occupation Tax Act and the Service Use Tax Act rather than the Retailers' Occupation Tax Act or Use Tax Act.

You informed us by telephone that the purchase order for the conveyor system was accepted outside of this State and that the materials used in constructing the conveyor system were taken out of an inventory that was not located in this State. Based upon this, the sale of the conveyor system is not taxable under the Service Occupation Tax Act. If the sale had occurred in this State, then the sale would have been taxable under the Service Occupation Tax Act. In that case, the amount of Service Occupation Tax incurred by the seller would have been based upon the cost price of the tangible personal property transferred incident to the sale of service as provided in Section 3-10 of the Service Occupation Tax Act. Section 3-10 of the Service Occupation Tax Act provides that when a serviceman contracts to design, develop, and produce special order machinery or equipment, the tax imposed by this Act shall be based on the serviceman's cost price of the tangible personal property transferred incident to the completion of the contract. See 35 ILCS 115/3-10 (1998 State Bar Edition).

COMPANY will incur Service Use Tax liability based on BUSINESS' cost price of the tangible personal property (materials) transferred to COMPANY incident to the completion of the contract to construct the special order conveyor system. See 35 ILCS 115/3-10. You also informed us by telephone that BUSINESS is registered as a retailer/serviceman in this State. Since BUSINESS is registered in this State, it is required to collect from COMPANY the Service Use Tax liability that

COMPANY incurs on tangible personal property transferred incident to the purchase of the conveyor system. See 35 ILCS 110/9.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have questions regarding this Private Letter Ruling you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Terry D. Charlton
Associate Counsel

TDC:mks

¹ For example, BUSINESS's website describes it as the "industry leader in material handling systems engineering, design, and manufacturing." BUSINESS Website, [News](#) p.1. BUSINESS states on the website that its strengths include a "commitment to solving customers' problems" and the "development of material handling systems that meet customers' specific application requirements." BUSINESS Website, [At a Glance](#), p. 1. The website also lists examples of products "developed in response to the requirements of [its] customers." BUSINESS Website, [Research and Development](#), p. 1.

² The 30-40 percent is determined as follows:

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| • Total Cost to design, engineer, manufacture, and install the material handling system. | 100% |
| • Cost of Machinery (i.e., cost to BUSINESS of materials, fabrication labor by BUSINESS, and BUSINESS's overhead) is 55 percent to 70 percent of the Total Costs mentioned above. | 100% x 55%=55% 100% x 70%=70% |
| • Approximately 57 percent of the Cost of Machinery is directly related to Material Costs for the conveyor components. | 55% x 57%=31% - rounded 30% 70% x 57%=40% |
| • Engineering, design, fabrication labor, overhead, and installation represent the remaining costs. | 100% - 31%=69% - rounded 70% 100% - 40%=60% |